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DESIGNING A DEFERRED COMPENSATION PROFIT SHARING PLAN FOR A SMALL COMPANY

DONALD C. LUBICK*

The following colloquy takes place early in December, 1953, in the offices of White and Brown, attorneys for the Buffalo Furniture Manufacturing Company, between John White, attorney, and Carl Jeffries, president and majority stockholder of the Company.

JEFFRIES: John, there's one more problem I have and that is our compensation problem. As you know, we have had a spotty earnings record over the last ten years, but with the great success we've had in marketing our new lines, we showed good black figures the last two years and this year will be the biggest yet.

WHITE: What are future prospects?

JEFFRIES: Of course, one never can tell—ours tends to be an up and down business anyway, even if the economy remains stable, and we have frequently been pinched for cash, but if our sales force and management can keep on the ball, I think we should be able to continue to have high profit years.

What has been bothering me about our compensation problem is twofold. First of all, some of our oldest loyal employees are getting close to retirement age. We've never had any definite program set up to take care of them, but obviously social security is not going to be enough for them to live comfortably and many have not accumulated any large savings.

Second, I and the rest of management have kept our salaries lower than they ought to be in the light of the present business of the Company. At first we did it to help the Company over some hurdles and then we got caught under the Salary Stabilization freeze. We would like some way to take higher salaries in good years, although we are willing to take cuts in lean years.

WHITE: I think I may have a partial answer to both your problems. Have you ever considered a profit sharing retirement plan?

JEFFRIES: I've heard of them—many of our competitors have them—but I'm a bit hazy on how they work.

WHITE: Basically the idea is quite simple. You take a portion of your profits and contribute it to a trust fund. Each of

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A DEFERRED COMPENSATION PROFIT SHARING PLAN

your employees has an account in the trust fund to which a share of the contribution is credited. The trustee invests the contributions and the earnings are also credited to the employees. At specified times such as retirement, death, disability or severance of employment, the employee or his beneficiary receives his account. The important thing for you is that unless the Company earns profits, you don't pay out anything. And of course the better your year, the more you put in.

JEFFRIES: Can you be a little more definite on how this will solve my two problems?

WHITE: Yes. To begin with, I am suggesting that you use a qualified plan and trust. By that I mean one which meets certain requirements set forth in Section 165 (a) of the Internal Revenue Code, and as a practical matter, the Treasury regulations and rulings under that Section. If you use a qualified plan and trust, you will become entitled to very significant tax advantages.

First of all, the Company, within certain limits, will get a tax deduction for its contribution against the year's profits.¹ Since you make contributions only in profitable years, it is to your advantage to get your deduction in such years, when you are sure to have taxable income, even though the money is not received by the employees until later years. Thus the tax collector will foot part of the bill for your retirement plan.

Second, the employee pays no tax on the money contributed by the Company for his account until he receives it.² This means if you are setting aside something this year for an employee's retirement, he won't be taxed on it this year on top of his other earnings, but will be taxed only at retirement when he receives it and his earnings are down. This is particularly advantageous to you because of your present high tax bracket. While you would like to get more salary now, wouldn't you prefer it if a sum were set aside for you now, which you would draw on at and after

1. INT. REV. CODE § 23(p) (1). Subparagraph (E) gives an accrual basis taxpayer sixty days after the close of the taxable year in which to make actual payment. See p. 230, *infra*.

2. INT. REV. CODE § 165(b). The exact language of the statute as to the time of taxation is "in the year in which so distributed or made available . . ." The distribution to an employee by a qualified trust of any annuity contract which the employee may surrender for a cash value does not result in taxation to the employee of such cash value until he actually surrenders the contract, however. U. S. Treas. Reg. 118, § 39.165-6 (a) (2). Compare this favorable treatment with the distribution to an employee of such a contract not through the medium of a qualified trust. The entire value of such an annuity will be taxable to the employee in the year of distribution, even if he cannot assign, surrender or commute the contract. *Hackett v. Commissioner*, 159 F. 2d 121 (1st Cir. 1946); *Oberwinder v. Commissioner*, 147 F. 2d 255 (8th Cir. 1945); *U. S. v. Drescher*, 179 F. 2d 863 (2d Cir. 1950), *cert. denied*, 340 U. S. 821 (1950); *Morse v. Commissioner*, 202 F. 2d 69 (2d Cir. 1953).

retirement when your tax bracket is much lower? In other words it is more advantageous for you to save for old age out of currently untaxed money, than to receive higher pay currently, on which you must pay taxes now, and save after taxes. Also under certain circumstances you can get your money out of a qualified trust as a long term capital gain at a maximum tax rate of 25%,³ and in your tax bracket that is certainly an advantage.

Third, the trust fund in which the profit sharing contributions are accumulated pays no tax on its earnings.⁴ If it earns 4% on your share, that is certainly better than if you invested your own money at 6%, but paid tax on the income.

JEFFRIES: That sounds like the perfect way to meet part two of my problem—greater effective compensation for management. You're absolutely right—we would like a way to put away money with the tax deferred until later. The effect will be to give us more spendable money now by relieving our individual savings programs of some of the strain of high taxes.

I also like the idea that greater contributions will be made if the Company makes greater profits. That will give everyone a direct stake in the success of the Company and an incentive to do better work. Now is this going to solve my retirement program needs also?

WHITE: I'm afraid it will only be a partial solution there, but the best we can do in the light of the Company's financial history. There are two reasons for this. First, if the Company does not continue to earn profits, not enough will be built up in the trust fund to provide any kind of a decent pension. Of course, if profits grow by leaps and bounds, perhaps there will be more available for pensions than anticipated.

Second, your older employees have been with the Company a long time. Nothing has been accumulated during all these years for their pensions on account of past service. Younger employees will be in the plan and share profits for twenty, thirty or more years, so that at their retirement a considerable sum will have been accumulated. But your oldest employees, who will have been in the plan only a few years before retirement, will not have a chance to accumulate very much. We can rectify this somewhat by giving older employees a larger share of each con-

3. When the total distributions payable with respect to an employee are paid to the distributee within one taxable year of the distributee on account of the employee's separation from the service of the employer. INT. REV. CODE § 165(b). Separation from the service includes death, retirement, resignation or discharge.

4. INT. REV. CODE § 165(a).

A DEFERRED COMPENSATION PROFIT SHARING PLAN

tribution based upon their longer service. But even that won't fully compensate for the fewer contributions to their accounts because of the shortness of time to their retirement. Besides that contributions in the fund invested on their behalf will have a shorter time to compound earnings.

The only ways to handle the past service problem, I am afraid, are either to set up a supplementary pension plan, which will provide a definite fixed benefit for these older employees, or to meet their pension requirements on a pay-as-you-go basis when they retire, paying them something extra out of the cash box to the extent you can afford it.

I do not think the former alternative should be chosen just now, because it involves a fixed commitment by the Company to pay an annual sum for pensions, regardless of profits.⁵ Since you have not built up any surplus, a few bad years might leave you so short of cash you would not be able to meet the pension fund requirements and you would have to abandon the plan. That would be very bad for employee morale. On the other hand, if you merely miss a few profit sharing contributions, the employees will understand that it is because there are no profits, and will work harder to create profits for the Company.

JEFFRIES: I agree with you, John, we can't stand any fixed commitment at this time.

WHITE: Of course, Carl, later you may find you can afford a small fixed commitment and then you can set up a supplementary pension plan. This can cover all employees, or you can limit it only to past service, that is, to pay a pension based on the period of service before the profit sharing plan started to work providing pensions for current years of service. And from the point of view of meeting the Treasury requirements to qualify your plan for the tax advantages we have been talking about, it is safer to start with a modest program such as a profit sharing plan involving no fixed corporate commitment. The Treasury will have no objection to your expanding your employee benefit program. If, however, you start out with a fixed commitment pension plan, and in a few years the burden proves too large, so that you are forced to curtail benefits and your contributions, you lay yourself open to attack by the Treasury on the ground that your plan was not a bona fide plan for the benefit of employees.⁶ This conceivably

5. U. S. Treas. Reg. 118, § 39.165-1 (a) (2). Either benefits payable or contributions must be susceptible of actuarial determination.

6. Min. 6136, 1947-1 CUM. BULL. 58; Rev. Rul. 32, 1953-1 CUM. BULL. 265; P. S. 60, P-H PENSION AND PROFIT SHARING SERVICE (cited hereafter as "P-H") ¶ 9559 (1947).

BUFFALO LAW REVIEW

could result in retroactive disallowance of deductions. The Treasury has set up very many rules concerning these deferred compensation pension and profit sharing plans, and the employer who does not heed them jeopardizes the favorable tax treatment I have been telling you about.

JEFFRIES: We certainly want to be sure to get the tax benefits. How do we know our plan meets the Treasury requirements?

WHITE: Fortunately the Internal Revenue Service will give us an advance opinion ruling as to whether our plan and trust meet the requirements of Section 165 (a). Then so long as the operation of the plan continues to meet those requirements, you are assured of favorable tax treatment.

JEFFRIES: What are these Treasury requirements for profit sharing plans?

WHITE: We can start with Section 165 (a) of the Internal Revenue Code. This section exempts from taxation a trust used to fund benefits under a profit sharing plan of an employer for the exclusive benefit of his employees or their beneficiaries if the trust meets certain requirements, namely:

1. Contributions are made to the trust for the purpose of distributing principal and income under the plan to employees.
2. The trust prohibits the diversion of the fund for purposes other than the exclusive benefit of the employees or their beneficiaries; to oversimplify, this means the Company can't get back any money it once puts into the trust.
3. Certain coverage requirements are met with respect to employees benefited.
4. The contributions and benefits "do not discriminate in favor of employees who are officers, shareholders, persons whose principal duties consist in supervising the work of other employees, or highly compensated employees." This is one of the most important and controversial requirements.

Now then if our trust and plan meet the requirements of 165 (a), the trust is exempt from taxation on its income. In addition Section 23 (p) of the Code provides that employer contributions to the trust up to certain amounts are deductible in the year of payment. And Section 165 (b) provides for the deferral of taxation to the employee of amounts credited to him in a 165 (a) trust until actually distributed or made available to him. If the employee receives his total distribution from the trust in one taxable year on account of retirement, death or other severance of employment, he gets long term capital gain treatment. Thus you

A DEFERRED COMPENSATION PROFIT SHARING PLAN

see how important it is to meet the requirements of Section 165 (a); otherwise the Company may lose a deduction of many thousands of dollars; the trust income will not be accumulated tax free and the employees may conceivably be forced to pay tax on money they won't actually get for several years.

JEFFRIES: Are these requirements hard to meet?

WHITE: We have to do more than meet these requirements. We have to satisfy the Internal Revenue Service that our plan meets these requirements as interpreted by over a hundred Treasury regulations and rulings. I think some of these Treasury interpretations are dubious, to say the least, and misinterpret the language of Section 165 (a).

JEFFRIES: Do we have to comply with rulings that are wrong?

WHITE: Technically, no. Failure to comply means only that we won't get an advance ruling that the plan and trust are qualified. Then if the Internal Revenue Service thinks our plan is not qualified, they may assess a deficiency against you, disallowing your deduction for your contribution, or attempting to tax the trust or the employees as if the trust were not qualified. We can then go to court and if the Tax Court or District Court thinks our interpretation is right, our deduction will be allowed.

JEFFRIES: Well, the prospect of going to court doesn't appeal to me.

WHITE: Exactly. Even if we win, and in a tax case few would be so hardy as to guarantee victory, it would be a long and costly battle. And if we lost, the disallowance of the deduction would be a calamity defeating all the benefits of the plan. So we must as a practical matter reckon with the Treasury rulings to get an advance approval opinion and work within that framework. Before we put twenty or thirty thousand dollars into a trust from which it is not recoverable, we want to make sure of our tax consequences.

JEFFRIES: Let us take it as settled that we must secure an advance opinion ruling on our profit sharing plan. Can you give me more details as to how it will operate?

WHITE: Yes, I want to go over the questions that must be decided before we can put the plan into effect. You will have to make many decisions affecting the way the plan shapes up.

I suppose as good a place to start as any is the question of cost. How much should the Company contribute each year and by what formula will the size of the contribution be figured?

BUFFALO LAW REVIEW

JEFFRIES: Do we have to commit ourselves to a definite formula? Why can't we just determine the amount at the end of the year?

WHITE: That is one of the bones of contention between the Treasury and the courts. The courts have held that the absence of a definite formula will not disqualify a plan under Section 165 (a)⁷ but the Internal Revenue Service will not give an advance ruling approving a plan without one.⁸

JEFFRIES: Can you give me an example of what the Treasury will approve as a definite formula?

WHITE: The most frequently used formulae are expressed in terms of a specified percentage of profits. It is permissible to use a formula of a percentage of profits in excess of dividend commitments plus a fixed amount,⁹ or a percentage of the employees' compensation (say 10%) out of profits.¹⁰ In the latter case, however, it must be clear that the contribution is to be made only to the extent there are profits; if the contribution is to be made regardless of profits, we have a so called money purchase pension plan, not a profit sharing plan, because the benefits may be determined actuarially.¹¹

The formula may contain variable factors affecting its size, if such factors are not within the employer's discretion.¹² For example, you may contribute 10% of the first \$25,000 of profits, 15% of the next \$25,000 and 20% of the excess.

You may set up certain reserves as deductions from your gross income in arriving at the amount of your profits for the purposes of your formula, such as reserves for depreciation or contingencies. But to be acceptable to the Treasury, the size of reserves used as deductions in computing profits for your contribution formula must not be discretionary with the company, or its directors. Only non-discretionary reserves, that is, reserves whose size is controlled by independent outside factors or by a mathematical formula are permissible.¹³ Otherwise the directors could affect the size of the profit sharing contribution at their whim by creating new reserves. The formula would then not be definite.

7. *The Lincoln Electric Co. Employees' Profit Sharing Trust v. Commissioner*, 190 F. 2d 326 (6th Cir. 1951); *Produce Reporter Co.*, 18 T. C. 69 (1952) Nonacq., 1952-2 CUM. BULL. 5, *aff'd*, 207 F. 2d 586 (7th Cir. 1953).

8. U. S. Treas. Reg. 118, § 39.165-1 (a) (2); I. T. 3661, 1944 CUM. BULL. 315; non-acquiescence in *Produce Reporter Co.*, *supra* note 7.

9. I. T. 3661, *supra* note 8.

10. P. S. 24, P-H ¶ 9522 (1944).

11. *Ibid.*

12. P. S. 33, P-H ¶ 9531 (1944).

13. P. S. 21, P-H ¶ 9519 (1944).

A DEFERRED COMPENSATION PROFIT SHARING PLAN

JEFFRIES: Can you give me some examples of acceptable and unacceptable reserves?

WHITE: A specified percentage of capital, such as a reserve for contingencies equal to 10% of book net worth as shown on the previous years' balance sheet, is mathematically determinable, and hence acceptable.¹⁴

A reserve for dividends on common stock as voted by the board of directors or a reserve for contingencies in such amount as the directors deem proper would be unacceptable because they are purely in the directors' discretion.¹⁵

On the other hand a reserve for dividends equal to average dividends paid over the preceding five years is acceptable because the directors can't very well use their whim to affect its size in any one year.¹⁶

JEFFRIES: Do we have to define "profits" any further than specifying what reserves we shall deduct before arriving at the figure?

WHITE: Apparently it need not be defined in the plan,¹⁷ but it certainly is a good idea to do so to eliminate possible disputes as to the amount of profits. Perhaps the best way to begin is to use your corporation surtax net income for the year, disregarding the profit sharing contribution deduction itself, as a starting point;¹⁸ then you may wish to deduct extraordinary and non-operating items before applying the percentage to the profits to be shared. For example, perhaps capital gains and losses should be disregarded in determining profits because they are unusual and non-recurring and are not accurately part of your income from the year's operations. You may feel the same way about loss carry-overs. This is in line with your idea that the profit sharing contribution is a reward for the employees' part in the *operating* success of the Company for the year.

14. *Ibid.*

15. *Ibid.*

16. *Ibid.*

17. Letter ruling of Dep. Comm'r, August 18, 1944, reported in P-H ¶4112. See P. S. 40, P-H ¶9538 (1944).

18. This involves simplicity of accounting, making it unnecessary for the corporation to calculate book income as distinguished from tax return income. If, however, the corporation wishes to use book income, the Internal Revenue Service reviewer may require a specific provision in the plan forbidding discretionary reserves as offsets against income. See P. S. 40, *supra* note 17, and P. S. 21, *supra* note 13. Such a provision is unnecessary, of course, if tax return income is used because tax return income is, in theory at least, a mathematically definite figure. Furthermore the use of tax return income insures a deduction related to taxes payable; book income conceivably could exist in circumstances where there is no tax return at all.

BUFFALO LAW REVIEW

JEFFRIES: Now wait a minute. I have a practical question. You said before we could get a deduction against the year's profits which are being shared. We want our deduction based on 1953 profits to be taken in 1953, but we can't make payment in 1953 because our accountants won't have completed our 1953 figures until early 1954.

WHITE: No cause for worry. Section 23(p)(1)(E) gives a break to accrual basis taxpayers. You have sixty days after the close of the taxable year to make your contribution based on your accrued liability for the taxable year. And even if you can't get your figures out within sixty days, you may provide in the plan for the making of your contribution based upon estimated profits determined in accordance with established accounting principles consistently applied to your data available before the sixty days are up and certified to by a responsible officer of the Company.¹⁹

JEFFRIES: Do we have to readjust our contribution if it turns out our income calculation was wrong or a revenue agent takes issue with some item in our return?

WHITE: No, I would provide in the plan that the determination made in good faith by your outside accountants or chief accounting officer is final and conclusive as to the amount of your income for profit sharing purposes, and is not subject to later readjustment. You must have some finality and such a provision should be acceptable to the Treasury.²⁰

JEFFRIES: I agree that we should use tax return income as a base; for accounting simplicity we have found that it is easier not to have to worry about two income figures. I think we should also exclude from our determination of profits all those non-recurring items of income and expense that are not related to the current year's operations. I would also like to set up a special reserve before profit sharing based upon ten per cent of the net worth as shown on our balance sheet as of the close of the previous year. And I like the idea of increasing the percentage to be shared as income increase. The more we make, the more we should share, especially if stockholders have already gotten a fair return on their investment.

WHITE: We can work out for you the size of your contribution based on applying various percentages to your income over the past five or six years. Then you can pick the most suitable percentages under some scheme, such as ten per cent of the first

19. P. S. 46, P-H ¶9544 (1945).

20. *Ibid.*

A DEFERRED COMPENSATION PROFIT SHARING PLAN

\$25,000, twenty per cent of the next \$25,000 and twenty-five per cent of the excess.²¹

One more thing to consider is a ceiling on your contribution. The basic limitation on the amount deductible in any one year by the company on account of contributions under a profit sharing plan is fifteen per cent of the compensation otherwise paid or accrued during the taxable year to all employees under the plan.²² If less than the fifteen per cent is contributed in any year, the unused amount of deduction may be carried forward and added to the maximum deductible in succeeding taxable years, but the total amount deductible in any year on account of such unused previous deductions also may not exceed fifteen per cent of the compensation paid or accrued during the year of deductions.²³ Thus conceivably as much as thirty per cent of compensation may be

21. Some companies prefer a formula calling for a percentage of profits after taxes, rather than before taxes. This has two advantages. First, the percentage contribution is higher and thus helps sell the plan to the employees as a generous one. For example, if a corporation has \$100,000 of income before taxes and wishes to contribute about \$25,000, its formula would call for a contribution of twenty-five per cent of profits. It could make approximately the same contribution (with exactly the same financial result) under a formula calling for a contribution of about forty-five per cent of profits after taxes. Thus the employees in the latter case are more likely to regard themselves as partners with stockholders.

Second, if taxes go down there are extra profits which are shared by the employees as well as stockholders. If the corporation has more money left because of lower taxes, it should be willing to give some of that money to employees, under the theory that taxes are in reality a legitimate current expense of operation. The real operating income of the company is after all only what is left after taxes. Shareholders do not receive dividends out of profits before taxes. If income taxes are a current operating expense, they should be deducted before determining profits to be shared.

The disadvantage of a formula for profit sharing after taxes is that some simplicity is sacrificed in calculating the profit sharing contribution. Since the profit sharing contribution is a deduction in computing income taxes, the income taxes cannot be known until the profit sharing contribution is known. But the profit sharing contribution, being dependent on income taxes, cannot be known until income taxes are known. This Alphonse-Gaston situation can readily be solved with the use of elementary algebra:

Let C = the profit sharing contribution.

Let I = federal tax return income without the profit sharing contribution.

Let T = federal income taxes.

For simplicity state income taxes may be eliminated as a deduction in arriving at I, or may be computed hypothetically as if there were no profit sharing contribution, and then deducted from gross income to arrive at I. Although the actual state income tax payable may depend upon the profit sharing contribution, the elimination of an extra interlocking calculation is worth a slight sacrifice in preciseness.

Assume a contribution formula of fifty per cent after federal income taxes. Assume a tax rate of thirty per cent of normal tax net income and twenty-two per cent of surtax net income in excess of \$25,000. Assume that normal tax net income and surtax net income are the same, \$100,000 without a deduction for the profit sharing contribution.

Then $C = 50\% (I - C - T)$

$T = 52\% (I - C) - 5500$

\$5500 is twenty-two per cent of \$25,000, not subject to surtax. Substituting for T and I, and cancelling out certain figures,

$C = 50\% (100,000 - C - 52000 + .52C + 5500)$

22. INT. REV. CODE. § 23(p)(1)(C).

23. *Ibid.*

deductible in one year, if the formula calls for so large a contribution and there are unused amounts available as a deduction from previous years. This has the ultimate effect of permitting you to contribute as much as fifteen per cent of a compensation averaged over the life of the plan.

I assume that if the contribution formula calls for a contribution greater than the amount allowable as a deduction, you will not want to pay out a contribution greater than the amount allowed as a deduction, even though the Code allows you a carry-over to later years on account of excess deductions.²⁴ This carry-over for excess deductions must be distinguished from the carry-over for unused deductions.

Therefore you may place a ceiling on contributions for any taxable year of fifteen per cent of the compensation otherwise paid or accrued to employees under the plan, or if you wish to go further, you can take advantage of carry-overs on account of earlier years in which you failed to use the full amount deductible, by providing a ceiling on contributions equal to "the maximum amount deductible under Section 23 (p)(1) (C) of the Code."²⁵ Either ceiling will avoid contributions in any year in excess of which will not be allowed as deductions for that year.

JEFFRIES: I think the last ceiling would give us more flexibility and we don't object to greater contributions if the formula calls for them, because that would probably indicate profits are up. But we do not wish to make a contribution in excess of the amount deductible, even if we get a carry-over. Taxes eat into profits enough without making non-deductible expenditures which might leave nothing to credit to surplus.

WHITE: While we are on the subject of contributions, you might also bear in mind that it is possible to make your plan more of a savings plan by permitting employee contributions to the trust. In that way the employees' savings which are held in the exempt trust will earn income which will not be taxed to them until retirement when they start drawing it out of the trust.

JEFFRIES: I think we prefer a noncontributory plan for the present, because if we introduce a supplementary pension plan later, we may ask the employees to share some of the cost. However, I admit that a contributory feature would make the retirement benefits for older employees look bigger.

WHITE: I think we have hit all the important problems in connection with contributions. Once we have figured out the

24. *Ibid.*

25. Min. 6131, 1947-1 CUM. BULL. 21.

A DEFERRED COMPENSATION PROFIT SHARING PLAN

amount of the annual contribution, we next face the problem of who is eligible for coverage.

Section 165 (a) (3) sets up three alternatives as to coverage any one of which is sufficient to qualify the plan, if met. The first is seventy per cent of all the employees. The second is eighty per cent of all the eligible employees, if seventy per cent of all the employees are eligible. These percentages are applied to your employment roll after excluding part-time and seasonal employees and employees who are excluded from coverage under the terms of the plan for failure to meet a minimum service requirement of five years or less. The second alternative need not concern us. Since our plan is noncontributory, all of the eligible employees will be covered anyway.

If all your full-time employees are covered, except for those excluded on account of insufficient service with the Company, we will have no trouble on the score of coverage. But since all your hourly employees are covered under a collective bargaining agreement, you cannot unilaterally install the profits sharing plan without bargaining with the union.²⁶

JEFFRIES: Can't we exclude the union employees? We are going to have to bargain with them on pensions next year anyway, and I think the profit sharing plan will be unacceptable to them.

WHITE: In effect we can do it by excluding from eligibility all hourly employees,²⁷ but then we will have to meet the third alternative, the test of Section 165 (a) (3) (B). We will have to include "such employees as qualify under a classification . . . found by the Commissioner not to be discriminatory in favor of employees who are officers, shareholders, persons whose principal duties consist in supervising the work of other employees or highly compensated employees; . . ."

Section 165 (a) (5) states that a classification limited to salaried or clerical employees will not of itself be discriminatory. Therefore we will have no trouble under labor laws or the Revenue Code if we include all your full-time salaried employees and exclude all your hourly employees. Since your clerical employees are paid on a salary basis, the plan will not be confined to persons in favor of whom discrimination is barred.

26. See *N. L. R. B. v. Black-Clawson Company*, 210 F. 2d 523 (6th Cir. 1954).

27. Care should be expressed not to commit an unfair labor practice by expressing the exclusion in terms of union membership, cf. *Jandel Furs*, 100 N. L. R. B. 1390 (1952), or even in terms of inclusion in a collective bargaining unit regardless of union membership. Cf. *Inter-State Motor Freight System, Inc.*, N. L. R. B. Div. of Trial Examiners, Case No. 14-CA-830 (1952).

BUFFALO LAW REVIEW

Also, we should set up some eligibility requirements with respect to service and age. Since most of your employment turnover is in the group of employees with few years of service, it would be a good idea to set up as a requirement to be covered under the plan that an employee complete at least three years of service in the Company. (We can include time spent on military or non-military leave of absence.) Also, since turnover is highest with respect to the youngest employees, I would suggest a minimum age of thirty for coverage under the plan. The exclusion of younger employees will mean larger shares for older employees and less shrinkage in the fund available for retirement benefits on account of participants leaving your employ and taking some of the fund with them. Those younger employees who stay with you, will make up for the years of non-eligibility by larger shares once they became eligible.

The question of a maximum age limit is more difficult. Since you want to benefit your older employees, I suggest that no maximum age limit be placed on eligibility as to present employees. However, you may want to exclude future employees over age fifty-five from becoming eligible.²⁸ If, however, you feel an obligation to provide some small retirement benefit for their few remaining years of service, and if you think the incentive feature of the plan will help their work, there should be no maximum age limitation.

JEFFRIES: I think we should eliminate any maximum age limitation whatsoever in order to provide some benefit for all employees and to give them all equal incentive. It is unlikely that we would hire many persons after age 52. With the three years waiting period for eligibility, the effect on the size of the profit shares of the others if future employees over age 55 are included would not be noticeable.

WHITE: Very well, then. Now having passed the questions of the amount of contribution and who is eligible to share in it, we come to the problem of how to allocate the contribution among employees. Again the chief problem we have to face is avoiding the discrimination prohibited by Section 165 (a).

The most usual method of allocation among participants in the plan is in proportion to compensation received during the year for which the contribution is made. In your case, however, I think we will want to give credit for years of service in the Company as well, by weighting allocation in favor of employees

28. Discrimination between present and future employees is not prohibited by § 165(a) unless incidentally it results in discrimination in favor of those persons mentioned in § 165(a)(3)(B). Rev. Rul. 33, 1953-1 Cum. BULL. 267, Part 4(d).

A DEFERRED COMPENSATION PROFIT SHARING PLAN

having more service. We must be careful in weighting contributions for service, however, lest the Treasury find discrimination if the higher paid employees benefit unduly by receiving credit for service because they are the only ones with long service.²⁹ Your highest paid employees do not have such long service, compared to the others however, that we can expect trouble on that score. I would suggest that each year we give one profit sharing credit for each \$200 of includible compensation and one profit-sharing credit for each year of service. Then we shall allocate the contribution for that year among the participants in proportion to their profit-sharing credits for that year.

JEFFRIES: That sounds good to me. I think we should see how it works out on paper, however. I'll have the comptroller work out a chart on that basis.

WHITE: As a matter of convenience we can further provide that employees on leave of absence during a part of the year will share in the year's contribution receiving profit sharing credits based on the compensation they actually received during the year with full credit for all years of service, but employees on leave during the whole of the year will not share in that year's contribution at all, either on account of earnings or service, because they did not help to produce the profits to be shared.

We also may have to place some sort of ceiling on compensation taken into account for purposes of allocation to prevent allocation of too large an amount for the benefit of the highest paid employees. The Code says that a plan shall not be considered discriminatory merely because contributions bear a uniform relationship to total compensation,³⁰ and no exception is stated as to inclusion of bonuses, commissions and overtime pay.³¹

Nevertheless the Treasury conferees frequently contend that there is discrimination even where allocation is in direct proportion to compensation, if one or two employees' pay is considerably higher than that of all the others so that the amount allocated to them represents a high percentage of the total contribution. Frequently we have had to place ceilings of \$25,000, \$30,000 or \$50,000 on compensation included for allocation purposes. We can't predict what will be done, however, without looking at your whole salary structure. This is another instance where I think the taxpayer would be upheld in the Tax Court if allocation were based on full salaries, so long as the requirements of Section 23 (a) as to reasonableness of compensation are met.

29. Compare I. T. 3685, 1944 CUM. BULL. 324, with I. T. 3686, 1944 CUM. BULL. 326 for illustrations of acceptable and unacceptable formulae based partially upon service.

30. INT. REV. CODE, 165(a) (5).

31. Rev. Rul. 33, *supra* note 28, Part 5 (h).

BUFFALO LAW REVIEW

Another thing which perturbs the conferees when checking for discrimination is allocation based on compensation which includes bonuses paid at the discretion of the Board of Directors. Sometimes they require the exclusion of such bonuses from the definition of compensation.

JEFFRIES: I don't see how that can discriminate in favor of highly paid employees. After all, the same thing can be accomplished by raising salaries. What difference should it make whether a man is paid \$20,000 plus a \$10,000 bonus or a \$30,000 salary? When all is said and done, our compensation payments cannot get out of hand anyway or a revenue agent will disallow them as expense deductions.

WHITE: Yes, I agree. Distinguishing between compensation received on account of form—whether it is called salary or bonus—should not matter, particularly where the Company has historically paid part of its compensation in the form of bonuses (as an incentive payment) and such payments have been allowed as reasonable under Section 23(a). And after all, if the plan proves discriminatory later on in operation, its tax-exempt status is lost. This would prevent a Board of Directors from going overboard on large bonuses to top management in order to direct most of the profit sharing contribution to them.

JEFFRIES: We'll have to follow your recommendation on that after you see our pay roll figures, but I think it is only fair to include everyone's actual compensation regardless of source. After all, our salary scale purports to be a measure of a man's worth and if some of us have to take a cut-back in profit sharing, we are getting less than we are giving in the way of services.

WHITE: The next problems I want to take up with you concern benefits—retirement, death and severance. I presume you do not wish to permit withdrawals by a participant from his share in the fund while he is still employed.

JEFFRIES: Yes, that would defeat one of our purposes, to provide for periods of non-employment, whether for severance, retirement or disability.

WHITE: I suppose normally you would expect a man to retire at age 65—when his social security payments begin. But do you wish a man to be permitted to retire earlier?

JEFFRIES: Yes, if a man is disabled, or if he reaches age 60, I think he should be permitted to retire.

WHITE: In those cases a man's benefits would be based on the full value of his account at that time. I think whoever is administering the plan, your advisory committee or trustees,

A DEFERRED COMPENSATION PROFIT SHARING PLAN

should have discretion as to manner of payment after consultation with the participant. Ordinarily you would want to provide for periodic distributions, but there may be hardship cases where a lump sum payment would be desirable. So long as all employees are fully vested with the same benefits—that is, have an absolute right to receive eventually equivalent amounts based on their shares—such discretion is valid.³² I would suppose also you would want the same discretion as to manner of payment of benefits at normal retirement.

Now what about a man who reaches age 65? Do you want to permit him to continue working?

JEFFRIES: Yes. Many of our older men can continue to do a good job after 65. I think we should be authorized to permit a man to stay on after 65, if we think he can do a good job, and, of course, assuming he is willing to stay.

WHITE: Would you want him to continue sharing in contributions for years after he has attained 65, if he has not retired?

JEFFRIES: Yes, because he would be contributing to our profits or else we wouldn't continue him on the job. And also we want to help build up a larger retirement pension fund for our present older employees.

WHITE: Suppose an employee dies. I suppose his whole account should go to his beneficiary. The Treasury holds that in order for a plan to qualify, the employee must have an unlimited right to designate his beneficiary to receive death benefits.³³ This means that the death benefit is taxable in the employee's estate.³⁴ But if the employee's choice of beneficiary were limited to his family, the death benefit arguably might not be taxable in his estate.³⁵ The Tax Court has held that the latter type of provision will not disqualify a plan,³⁶ but so long as the Treasury sticks to its guns, we will have to comply or litigate.

JEFFRIES: So we have to comply as a practical matter.

WHITE: Yes. Now one more problem and that is severance benefits. It is usual to have what we call vesting provisions. An employee who is covered under the plan for a certain time becomes

32. Rev. Rul. 33, *supra* note 28, Part 5 (j).

33. U. S. Treas. Reg. 118, § 39.165-1(a)(1); Rev. Rul. 33, *supra* note 28, Part 2(c).

34. Under INT. REV. CODE § 811(f) as property over which the decedent had a general power of appointment, if not under § 811(a), property of the decedent, or § 811(c), transfers by the decedent to take effect at his death.

35. The decedent would not have a general power to appoint under § 811(f). It is beyond the scope of this paper to discuss whether the benefit would be taxable under § 811(a) or § 811(c), but the Treasury's position that benefits would be so taxable is at least doubtful.

36. *Meldrum and Fewsmith*, 20 T. C. —, No. 113 (1953).

absolutely entitled to a certain portion of amounts already to his credit in the fund, although the time of payment may be deferred. Of course once he severs employment, he would have no interest in subsequent contributions to the trust fund.

For example, we may say that an employee who terminates his employment will be vested with ten per cent of his account in the fund for each year of participation under the plan. The amount not vested when he quits will be forfeited to the fund and be allocated among the accounts of the other participants. We may wish to prevent a man who quits from receiving a lump sum which he can squander or use to compete in business with you, by providing for the deferment of payment of all or part of a man's vested interest. Of course, at normal retirement date, death, disability or early retirement, an employee's account will be fully vested, subject to your decision as to the time and manner of payment.

JEFFRIES: Is there any rule as to how rapidly vesting must occur?

WHITE: Actually the Treasury has said vesting is not a requirement of qualification.³⁷ But lack of vesting may result in discrimination if forfeitures are heavy on account of severance and are reallocated annually among the remaining participants, gradually funneling the fund into the accounts of a few highly paid participants. Turnover is usually low among the highly paid participants.

If turnover is not unusually high, a formula of ten per cent of a participant's account for each year of participation after he enters the plan will be acceptable. Many conferees have also taken the position that the rate of vesting can be much slower—say five per cent a year—if forfeitures arising from turnover during the year are not reallocated among the remaining participants, so that they might eventually benefit the highest paid participants, but rather go to reduce the employer's contribution for the year. Apparently the theory is that if the contribution is reduced by forfeitures, the total amount allocated for the highly paid employees (as well as for all other employees) will not be any greater than if there had been no forfeitures. Thus forfeitures will not result in discrimination in favor of highly paid employees.

At this point I had better explain that each year we should have a valuation of the fund before crediting the new contribution to the employees' accounts. The revalued fund (recognizing income earned, expenses incurred and gains and losses) is then reallocated among the participants in proportion to their accounts at the beginning of the year. Thus each participant is credited

37. P. S. 22, P-H §9520 (1944); Rev. Rul. 33, *supra* note 28, Part 5 (b).

A DEFERRED COMPENSATION PROFIT SHARING PLAN

with his share of increment or loss in the fund's value. Then the new cash contribution is allocated among the various accounts including those set up for new employees first entering the plan. The basic question if a slow rate of vesting is used is whether forfeitures are allocated among the accounts before or after the new contribution is allocated. In other words, do new participants share in forfeitures of the year preceding their entry into the plan?

JEFFRIES: I would like to have slow vesting, if possible, to discourage turnover and provide a greater amount for retirement. I have in mind twenty or twenty-five years.

WHITE: Then the Internal Revenue reviewer will probably insist that forfeitures be allocated to the accounts of the participants as a part of the new contribution, which will be reduced *pro tanto* by the amount of the forfeitures.

Now we come to problems of administration of the plan and trust. I understand it is your wish to use a corporate trustee to manage the fund as you don't have the time or knowledge to handle its investment.

JEFFRIES: That is right.

WHITE: Then we will have an advisory committee appointed by the company to administer the plan. It will determine questions of eligibility and form, time and manner of payment of benefits. When a man retires, it can direct the trustee to pay his benefits in cash or by purchase of an annuity contract for him or whatever is desirable. Incidentally, when a man retires, or severs his employment, his share of the fund should be segregated from the rest. He is no longer sharing in profits and it is no longer desirable to have him share in the general income of the trust or in forfeitures. It also presents accounting difficulties if his share is not segregated because payments will be made from it during the year, so you won't know easily how much of the general income of the trust is attributable to his account. However, to the extent his share is not used for the purchase of an annuity or immediate cash payments, it can earn interest in a savings account or in government bonds. At retirement I think investment should be more conservative so a man can rely on getting at least what has been accumulated for him to that date.

The advisory committee should also keep the records of each man's account. There is no need to pay the trustee for this routine bookkeeping since the advisory committee has to get up the compensation and service data necessary to determine the amount of these accounts anyway.

JEFFRIES: Can the company borrow money from the trust instead of from a bank?

BUFFALO LAW REVIEW

WHITE: That is a practice which should certainly be scrutinized before it is done, because of the self-dealing involved. The Treasury does not prohibit investment in employer securities but the Commissioner must be notified if the employer borrows from the trust or the trust invests in employer securities.³⁸

The main idea is that a plan must be for the exclusive benefit of the employees. So long as the trust is not used for other purposes, the Treasury should not object to any investment. But if the employer would not get credit elsewhere, and the trust lent him money, it would not be for the exclusive benefit of the employee, but rather would be a means of financing the employer.

JEFFRIES: I don't think it will hurt to have the power anyway.

WHITE: One more problem on investments. Many plans permit the investment of a portion of each employee's account in insurance on his life.³⁹ Particularly with younger employees, it helps them with their life insurance program at a time when such help is needed. Should the employee die unexpectedly, the profit sharing plan can then pay a substantial benefit to his beneficiary. At age 65 the insurance contracts can be converted into annuity contracts providing retirement income by the application of other funds in the employee's account. Sometimes a more favorable rate can be obtained than would be possible if the trustee went into the market to buy an annuity contract for the employee.

JEFFRIES: I like the idea, but suppose we have some bad years. How will the premiums be paid?

WHITE: We will not make any investment in insurance contracts until an employee has been a participant under the plan for two years. Then we can purchase insurance for his account in such amount as a fixed percentage, for example, fifteen per cent, of his account will buy. Thus the remaining eighty-five per cent of his account will provide a reserve for premiums for at least six years. The amount to be invested in insurance can be reviewed periodically and additional coverage afforded within limits fixed by the plan.

38. U. S. Treas. Reg. 118, § 39.165-1(a)(6); Rev. Rul. 32, *supra* note 6; Rev. Rul. 46, 1953-1 CUM. BULL. 287.

39. Life insurance contracts earmarked to the accounts of specific participants are permitted under Rev. Rul. 33, *supra* note 28, Part 5(g), if all participants have an equal right to direct a proportionate part of their interests to be so invested. See also letter rulings reproduced at P-H ¶ 9919. Rev. Rul. 54-51, I. R. B. 1954-8 and 9 permits such "incidental" investment in life insurance contracts where the "aggregate premiums for life insurance in the case of each participant is less than fifty per cent of the aggregate of the contributions allocated to him at any particular time" and the plan requires "the trustee to convert the entire value of the life insurance contract at or before retirement to provide periodic income so that no portion of such value may be used to continue life insurance protection beyond retirement."

A DEFERRED COMPENSATION PROFIT SHARING PLAN

JEFFRIES: Once we adopt the plan are we irrevocably committed to it?

WHITE: No. You may terminate your liability for further contributions at any time, if the plan so provides.⁴⁰ You may never recover any contributions, however, which have already been made to the trust.⁴¹

You may also amend or modify the plan freely, if the amendment does not divert assets of the trust from the exclusive benefit of the employees.⁴² Of course, if an employee has acquired a vested property right in certain assets of the trust, your amendment could not take that away.

If you abandon the plan entirely within a few years of its adoption, other than for business necessity, the Treasury will regard that as evidence that the whole plan was not *bona fide* from the beginning and may attempt to disallow all your previous deductions.⁴³ With a profit sharing plan it might be hard to show business necessity for abandonment because contributions need not be made in the absence of profits.

JEFFRIES: We're not planning to abandon the plan, so we have no worry on that score. Are there any other points to be covered?

WHITE: No, I think that covers all the points other than routine trust and administrative provisions which you can approve when I submit a draft of the plan to you.

JEFFRIES: I'm very pleased with the plan we have developed. And, of course, we shall consult you periodically to determine its adequacy in the light of our experience with it and our future economic position.

(The foregoing was written before the introduction of H. R. 8300, 83d Congress, 2d Session, called the Internal Revenue Code of 1954. Some of the more important changes proposed by the House Bill include statutory elimination of the definite formula requirement, statutory sanction of restrictions of an employee's power to designate the beneficiaries of death payments within a limited class and provisions as to allocation of benefits. Ordinary life insurance is eliminated as a permissible trust investment. It is difficult to know how much, if any, of the provisions of the H. R. 8300 will become law, but the draftsman of a profit sharing plan will be well advised to follow the progress of the legislation, both to avoid traps and to take advantage of liberalization enacted.)

40. U. S. Treas. Reg. 118, § 39.165-1 (a) (3).

41. INT. REV. CODE § 165(a) (2).

42. *Ibid.*

43. U. S. Treas. Reg. 118, § 39.165-1(a) (3); P. S. 7, P-H ¶ 9505 (1949).